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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION
OF ARIZONA-AMERICAN WATER
COMPANY, AN ARIZONA
CORPORATION, FOR A
DETERMINATION OF THE CURRENT
FAIR VALUE OF ITS UTILITY PLANT
AND PROPERTY AND FOR INCREASES
IN ITS RATES AND CHARGES BASED
THEREON FOR UTILITY SERVICE BY
ITS MOHAVE WATER AND
WASTEWATER DISTRICTS

DOCKET NO. WS-01303A-06-0014

STAFF'S CLARIFYING
COMMENTS TO
RECOMMENDED OPINION AND
ORDER

I. INTRODUCTION

On March 30, 2007, the Hearing Division of the Arizona Corporation Commission ("Commission") filed a Recommended Opinion and Order ("ROO") regarding Arizona-American Water Company's ("Company") application for a determination of the current fair value of its utility plant and property and for increases thereon for utility service by its Mohave water and wastewater districts. Staff respectfully submits the following clarifying comments to the ROO regarding cost of capital.

II. COMMENTS

A. Use of a Hypothetical Capital Structure

The ROO recommends the Commission adopt a hypothetical capital structure composed of 40 percent equity and 60 percent debt (ROO at 20). Staff's use of a financial risk adjustment provides the same benefits as the use of a hypothetical capital structure (Chaves Surrebuttal at 6). The Company notes that hypothetical capital structures are consistent with past Staff recommendations regarding energy utilities (Reiker Direct at 18). However, no financial risk

1 adjustment was proposed by Staff in any of the recommendations mentioned by the Company's
2 analyst (Chaves Surrebuttal at 5). In the event that the Commission were to adopt a hypothetical
3 capital structure in conjunction with a financial risk adjustment, the financial risk adjustment
4 should be modified accordingly to reflect the change in financial leverage that results from the
5 adoption of a hypothetical capital structure, which in this case would result in a lower financial risk
6 adjustment due to the lower amount of debt in the proposed hypothetical capital structure (Tr. at
7 431:21 – 432:1).¹

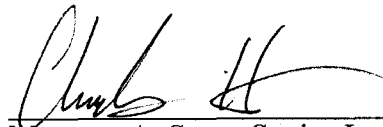
8 **B. Staff's Methodology to Estimate the Cost of Equity**

9 The ROO also states that Staff uses the DCF model as the primary basis for determining the
10 Company's estimated cost of equity capital (ROO at 19). Staff would like to clarify that it employs
11 several methods to estimate the cost of capital in rate proceedings. Staff estimates two Discounted
12 Cash Flow models and two Capital Asset Pricing Models and averages all four analyses to reach its
13 final cost of equity estimate (Surrebuttal Schedule PMC-2). Staff does not rely primarily on a
14 single method to estimate the cost of equity capital.

15 **III. CONCLUSION**

16 Staff therefore provides these clarifying comments, in lieu of exceptions to the ROO, for
17 the consideration of the Commission.

18 RESPECTFULLY SUBMITTED this 6th day of April, 2007.

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28 ¹ Specifically for the hypothetical capital structure recommended by the ROO, the financial risk adjustment would be 50 basis points resulting, in a cost of equity of 10.2 percent and a rate of return of 7.51 percent.

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2 of the foregoing were filed this
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4 Docket Control
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